RUNAWAY PRODUCTIONS: CLEARING UP THE CONFUSION

Introduction

After talking to and meeting with many people in the film and television industry, as well as heads of various State Film Offices, and after reading articles and listening to other entertainment attorneys, it has become evident that there is considerable confusion and misinformation about the tax benefits for independent film and television producers that are contained in the recently passed American Jobs Creation Act (the "Act"). Contrary to popular belief the Act can provide significant tax relief to those taxpayers who invest in qualifying film and television projects.

Overview of The American Jobs Creation Act

The Act took effect on October 22, 2004, and it will expire on December 31, 2008. It demonstrates that the United States is serious about finding ways to help the struggling film and television industry and reverse the trend of "runaway film productions." Internal Revenue Code Section 181, added by the Act, provides tax incentives for taxpayers to invest in film and television projects that meet certain criteria. Section 181 allows a taxpayer to deduct 100% of his, her or their investment in the year or years in which the investment is spent on film and television projects that have production budgets which do not exceed $15 million. The budget can be expanded to $20 million if its aggregate costs are "significantly incurred" in a depressed or blighted area, a low income area, or a distressed county or isolated area of distress as established under various regulations. Television productions are limited to a series of no more than 44 episodes. Relief under the Act is available to individuals and companies.

The Act requires that a minimum of 75% of any and all payments for services paid to actors, directors, producers, and other relevant production personnel be paid to people or companies in the United States. This effectively means that compensation to the screenwriter for the screenplay and other rights are exempt from the 75%. Any other budget items that are not payment for services as defined above are also exempt. This reduces the amount that a filmmaker needs to spend in the United States. In addition, the service personnel do not need to be U.S. citizens. They simply need to provide the service in the U.S. and be paid in the U.S. This means that talent from abroad can be brought in and the tax benefits will still be available. Further, film and television projects that show sexually explicit scenes are ineligible for tax benefits under the Act. For further information on the meaning and scope of the term "sexually explicit," please see Section #10 of this booklet. On February 22, 2005, the Directors Guild of America wrote a letter to the Legislative Counsel for the Joint Committee on Taxation corrective amendments to clarify certain points. Please see Section #5 of this booklet. On May 10, 2005, the DGA accountants, Ernst & Young wrote to the Treasury Department's Tax Legislative Counsel asking for guidance on 1) the treatment of residual and participation payments under the production cost caps; 2) the treatment of guarantor payments that are made when productions go over budget; and 3) the amount of expenditures that must occur in a low-income area to qualify for the higher $20 million production cost cap. Please see Section #6 of this booklet. The issues posed and questions asked are legitimate concerns that need answers. Answers will need to come soon.

Confusion and Clarification

After passage of the Act, many industry professionals and their legal and accounting representatives found the Act lacking in sufficient detail. This led to uncertainty and confusion. Rumors started to spread. Industry unions had concerns. Dealmakers and investors began to wonder: "Are deductions under the Act allowed only against passive income? Or, may the deductions be written off against any income?" The conservative approach many practitioners adopted was to tell clients that it is best to regard the loss as passive — at least until any amendments to the Act were passed or the IRS adopted regulations on these matters. No amendments have been introduced or regulations proposed that would clarify this point. As of this writing, there is no case that has applied the Act.

Recently, however, Congressional staff members have indicated that two amendments will be included in a bill making so-called "technical corrections" to the tax laws during the current Congress. Rumors have circulated that the amendments would ruin the effectiveness of the Act or even roll back its tax benefits to investors in film and television productions. Many people thought that write-offs under the Act would be expressly limited to passive losses. This, however, is not the case. No amendments have been introduced. If and when they are, they must receive the necessary votes for passage. For now, the Act stands as passed, and one should evaluate it as written.

If the sponsors wanted to require treating the write-off as passive losses, they would and could have easily included that restriction in the Act. It would have only taken a few words. Therefore, we believe that the correct interpretation of the Act is that the investment when made is an ordinary loss to be written off against all sources of income reported on one's tax return.

The Proposed Amendments

The anticipated amendments deal with two major areas of the Act and are being proposed as further clarifications to Section 181. The first point of the proposed amendments is that the income from sale of rights to the production for which deductions under the Act have been claimed will not to be considered "capital gain" for tax purposes. Also, income received on these productions will trigger "recapture" of the tax benefit and will effectively be ordinary income. Clearly, if the income is ordinary income, then the recaptured loss is an ordinary loss. The proposed amendments also clarify that any deferrals or residuals to those providing service to the production must be included in the budget limits. This change can easily be kept from disqualifying a domestic project for the Act's benefits by reducing one's budget to a "safe haven" amount which will reasonably prevent the production budget from going over the limits, even if deferrals and/or residuals kick in. If one's budget is equal to or less than $10 million, then the risk is slight and one is, with careful review, probably within the "safe haven" zone. If one does not consider the area of deferrals and/or residuals and goes over the limit allowed, then one will lose all benefits and be taxed without regard to Section 181. If the project turns out to produce so much revenue that residuals on a $10 million budget go over Section 181's limit, presumably the loss of tax benefits will not be too painful.

The Joint Committee on Taxation, in consultation with the Senate Finance and House Ways & Means Committee, on May 31, 2005 published General Explanation of Section 181 of the American Jobs Creation Act of 2004. It stated that for television series, the aggregate cost threshold and the seventy five (75) percent of total compensation test applied on an episode-by-episode basis. Please see Section 8 of this booklet in which this Joint Committee on Taxation General Explanation appears.

In addition to the ability to have taxpayers receive substantial tax reduction incentives under Section 181, the income received also has some tax reduction opportunities. Under the manufacturing sections of the Act, film productions and their respective companies in the film production business are considered "manufacturing businesses." Under these provisions, taxpayers can deduct 3% of the income they receive from the film project in the years 2005 until 2007. From 2007 until 2010 they can deduct 6% and from

2010 and beyond they can deduct 9%. This deduction does not apply to television productions. If $100.00 is received from 2005 up to 2007, then the taxable income is $97.00. If $100.00 is received from 2007 up to 2010, then the taxable income is $94.00. If $100.00 is received after 2010, then the taxable income would be $91.00.

More Good News

Additional good news for independent filmmakers is that the Act can be combined with any state film or television incentive programs. Currently, 44 states have incentive programs available to film and/or television projects. Producers and their tax advisers should evaluate projects to determine which state has the best incentives to add to those contained in the Act.

Despite some of the confusion and erroneous information surrounding the Act, it is a highly beneficial law for independent producers in film and television and can help put a serious dent into runaway productions. Until contravening amendments or tax regulations specifically indicate to the contrary (and presently none are pending), the Act will provide important tax relief to taxpayers investing in qualifying ventures.

Important Note

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